

Internal Revenue Service

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to: Internal Revenue Service, LMSB Denver
Attn: Dave Yager, Acting Team Managerfrom: Alice M. Harbutte, Attorney
LMSB Area 4, Natural Resources, Denver, Coloradosubject: [REDACTED], Inc./[REDACTED]
Taxable Year: [REDACTED]

This memorandum is in response to your request for an advisory opinion dated February 7, 2001, concerning the proper amount of foreign taxes deemed paid under I.R.C. § 902 that should be included in the foreign tax credit calculation of [REDACTED] ("[REDACTED]"). The deemed paid taxes relate to [REDACTED]'s interest in [REDACTED] ("[REDACTED]"). [REDACTED] is owned [REDACTED] % by [REDACTED] and [REDACTED] % by [REDACTED] ("[REDACTED]"). The taxable year in question is [REDACTED].

ISSUE

1. Whether [REDACTED] is permitted to include in its foreign tax credit calculation its share of deemed paid taxes under I.R.C. § 902 that relate to a UK mainstream tax liability, which was partially satisfied with ACT carryforward available for offset, attributable to ACT paid prior to the date any U.S. shareholder obtained an interest in the UK entities which paid the ACT.

2. Whether an adjustment pursuant to I.R.C. § 905(c) is required to be made by [REDACTED]

CONCLUSION

1. Under the Technical Explanation to the US-UK income tax treaty, ACT taxes are included as part of total foreign taxes paid by a UK subsidiary and used to compute a US shareholder's deemed-paid credit in the year the ACT was paid. However, if the ACT is later used to offset mainstream taxes for a subsequent tax year, the ACT tax paid in prior year is considered to be refunded and included in taxes paid by the UK subsidiary in the later tax year (the offset year). Thus, [REDACTED] may include in computing its deemed-paid credits with respect to dividends from [REDACTED] accrued mainstream corporation tax that is satisfied by an ACT

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carryforward in [REDACTED]'s pool of [REDACTED] foreign income taxes paid.

2. Under I.R.C. § 905(c), Treas. Reg. § 1.905-3T(d)(2) and (3) and the Technical Explanation there is an adjustment to [REDACTED]'s Earnings & Taxes ("E&T") in both the years of original payment and the offset year. E&T are revised to reflect a deemed refund of tax in the years in which [REDACTED] paid ACT, and a deemed payment of tax by [REDACTED] in the year the offset is allowed. While there is a deemed refund of tax to a pre-pooling year, there is no 905(c) adjustment at the shareholder level since the taxpayers in question did not claim any deemed paid credit at the time the ACT was paid. The ACT carryforward applied in satisfaction of [REDACTED]'s mainstream tax liability is included in [REDACTED]'s E&T for the offset year.

FACTS

[REDACTED] ("[REDACTED]") is a joint venture ([REDACTED]) formed in February [REDACTED] by two unrelated U.S. corporations, [REDACTED] Inc. ("[REDACTED]") and [REDACTED] Inc. ("[REDACTED]"). Both [REDACTED] and [REDACTED] are [REDACTED] companies. The [REDACTED] consolidated group has claimed foreign tax credits on its U.S. Corporate Return, Form 1120, for the [REDACTED] taxable year, some of which relate to foreign taxes shown as accrued on the [REDACTED] U.S. Partnership Return filed by [REDACTED] (the "[REDACTED] Form 1065").

[REDACTED] is a partnership for U.S. tax purposes since it checked the box on Form 8832 electing to be treated as a partnership for U.S. tax purposes. [REDACTED] filed a U.S. Partnership Return, Form 1065, for the year ending December 31, [REDACTED] and indicated on the return that it was a foreign partnership. Both partners of [REDACTED] signed an election for [REDACTED] to be treated as a TEFRA partnership for U.S. tax purposes for the [REDACTED] tax year. [REDACTED] was designated as tax matters partner on the [REDACTED] Form 1065.

[REDACTED] was formed as a UK private company for the purpose of acquiring [REDACTED] ([REDACTED]) a UK regional [REDACTED] company. This was accomplished on [REDACTED], when [REDACTED] acquired [REDACTED]% of [REDACTED]. [REDACTED] has numerous wholly owned subsidiaries, including [REDACTED] and an entity known as [REDACTED]. The total consideration paid by [REDACTED] for [REDACTED] was approximately \$[REDACTED].

On the [REDACTED] partnership return as originally filed, the partnership reported total foreign taxes of \$[REDACTED].

Statement [REDACTED] to this return identifies the tax as associated with Dividends that accrued on [REDACTED]. The original [REDACTED] Form 1065 also reported total dividend income in the amount of \$[REDACTED]. Statement [REDACTED] to this return classified \$[REDACTED] as UK/Northern Ireland General Limitation Income; \$[REDACTED] as UK/Northern Ireland Passive Income; and \$[REDACTED] as UK/Northern Ireland Dividends from section 902 Corp #1. Line 14b(1) of the [REDACTED] Form 1065 characterizes \$[REDACTED] of the dividend income as investment income. The agent represents that the dividend income includes the "gross-up" amounts under I.R.C. § 78 for purposes of determining the indirect credit under I.R.C. § 902. The primary expense reported on the original [REDACTED] Form 1065 was interest expense in the amount of \$[REDACTED]. This interest expense was incurred by [REDACTED] to finance the acquisition of [REDACTED] through [REDACTED].

On [REDACTED], [REDACTED], as TMP of [REDACTED], filed a Form 8082, "Notice of Inconsistent Treatment or Administrative Adjustment Request" with respect to the [REDACTED] Form 1065. The Form 8082 requested that it be treated as an Administrative Adjustment Request ("AAR"), and requested substitute return treatment for the entire partnership. Under I.R.C. § 6227(c)(1)(B) the Service may treat the changes shown on such request as corrections of mathematical or clerical errors.

The AAR substitute return showed several changes including a change in the amount of foreign taxes accrued. The revised amount, as shown on the AAR substitute return, is \$[REDACTED], and the AAR states this figure was adjusted to reflect the actual mainstream tax liability of the foreign corporation ([REDACTED]) used to compute deemed-paid taxes for [REDACTED]. The calculation of foreign taxes deemed paid submitted with the Form 8082 is attached as **Exhibit A**.

At the time [REDACTED] was acquired through [REDACTED] by [REDACTED], [REDACTED] had surplus ACT available to be used as an offset to UK mainstream taxes. The surplus ACT balance as of [REDACTED], was \$[REDACTED] attributable to ACT paid by [REDACTED] from [REDACTED] through [REDACTED]. The calculation of the surplus ACT is set forth on **Exhibit B**. In satisfying its UK corporate mainstream tax liability, [REDACTED] used an ACT offset (carryforward from pre-[REDACTED]) of \$[REDACTED] and made tax payments on [REDACTED] and [REDACTED] in the amounts of \$[REDACTED] and \$[REDACTED] respectively.

DISCUSSION

Issue 1

Foreign Tax Credit:

A tax credit is permissible under I.R.C. § 901 for foreign income taxes paid or accrued directly by a United States taxpayer, or deemed paid or accrued under I.R.C. § 902. Under I.R.C. § 902(a), a domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of such foreign corporation's post-1986 foreign income taxes as (1) the amount of such dividends (determined without regard to I.R.C. § 78) bears to (2) such foreign corporation's post-1986 undistributed earnings and profits. I.R.C. § 902(a). I.R.C. § 902(c)(3) provides that the foreign corporation's post-1986 undistributed earnings and foreign income taxes pools include only earnings and taxes beginning with the first taxable year in which the stock ownership requirements of I.R.C. § 902 are met. I.R.C. § 902(c)(6) provides that deemed-paid taxes with respect to distributions of earnings accumulated in years prior to the foreign corporation's first taxable year in which the stock ownership requirements of I.R.C. § 902 are met shall be computed in accordance with pre-1987 law. Treas. Reg. § 1.902-1(a)(13)(i) provides that such pre-acquisition earnings shall be treated as pre-1987 accumulated profits ("pre-pooling earnings").

I.R.C. § 901(b)(5) provides that individual partners may claim credits for their proportionate share of foreign income taxes of the partnership. The provision by its terms does not extend to corporate partners. However, I.R.C. § 702(a)(6) provides that each partner shall take into account separately his distributive share of the partnership's creditable foreign income taxes described in I.R.C. § 901. I.R.C. § 902 does not contain any attribution rules regarding the computation of deemed-paid taxes with regard to foreign stock held through partnerships. However, Rev. Rul. 71-141, 1971-1 C.B. 211, states that a corporate general partner is entitled to a credit for foreign taxes deemed paid under I.R.C. § 902 with respect to dividends on foreign stock owned by a domestic partnership.

UK Corporate taxes: ACT and Mainstream

For the years at issue in this case, under the Finance Act of 1972, a United Kingdom corporation had to pay 1) mainstream corporation tax, which is a tax on corporate income, and

2) advance corporation tax (ACT), a tax on any qualifying distribution to shareholders. Section 85 of the Finance Act of 1972 provided that ACT payments could be used by the payor United Kingdom corporation to offset its mainstream corporation tax (the "Section 85 offset" or "corporate offset"). Unused Section 85 offset is to be used to offset mainstream corporate tax for the payor corporation's two preceding taxable periods or carried forward indefinitely.

US-UK Treaty

The United States and the United Kingdom entered into the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains and Three Protocols, Dec. 31, 1975-Mar. 15, 1979, U.S.-U.K., 31 U.S.T. (Part 6) 5668, T.I.A.S. 9682 (the "Treaty"). Articles 23, ¶(1)(a) and 2, ¶(2)(b) provide that, for purposes of applying the U.S. credit, the United Kingdom income tax, capital gains tax, corporation tax and petroleum revenue tax are considered to be income taxes for persons entitled to the benefits of Article 23. Under Article 23, and in accordance with I.R.C. 902 or 960 of the Code, a direct investor is eligible to claim an indirect foreign tax credit for the appropriate amount of the UK tax paid by the corporation.

Article 10 of the Treaty, 31 U.S.T. at 5677, provides that shareholders owning at least 10 percent of the outstanding voting stock of a UK corporation are entitled to a payment of one-half of the shareholder credit to which an individual UK resident shareholder would have been entitled ("ACT refund"). Individual UK shareholders are entitled to ACT refunds when dividends are paid out of earnings with respect to which ACT was paid by the distributing corporations. Neither [REDACTED] nor [REDACTED] received any ACT refund with respect to the ACT paid by [REDACTED] in connection with dividends paid prior to their acquisition of [REDACTED] through [REDACTED].

The Technical Explanation to the Treaty explains that a U.S. shareholder of a UK corporation can claim a deemed paid foreign tax credit for ACT taxes in the year the ACT is paid. The resulting credit, however, is provisional. If the ACT tax is later used by the UK entity to offset its mainstream tax liability in a different tax year, the US shareholder that claimed the foreign tax credit in the year the ACT was paid must recompute its deemed-paid foreign tax credits in the earlier year without including the ACT tax. The ACT tax will be included in the UK subsidiary's creditable foreign income taxes in the year it is applied as an offset to the UK mainstream taxes. See

Technical Explanation of the Treaty, reprinted in 1980-1 C.B. at 473-74.

The taxpayer in the instant case has cited the Technical Explanation to support its position that the ACT carryforward amount that was used to satisfy a portion of its mainstream taxes for [REDACTED] is properly included in its deemed-paid foreign tax credit calculation for the [REDACTED] tax year.¹ The taxpayer may rely on the Technical Explanation so long as the position is consistently applied; therefore, the taxpayer's position is correct. Thus, [REDACTED]'s total foreign taxes shown on the substitute return for [REDACTED], in the amount of \$[REDACTED], which amount was satisfied by ACT offset of \$[REDACTED] and tax payments of \$[REDACTED] and \$[REDACTED], is correct absent some other computational error or issue not addressed in this memorandum.

Issue 2: I.R.C. § 905(c)

The examining agent has requested advice as to whether an adjustment under I.R.C. § 905(c) should be made in this case. Section 905(c) of the Code requires a recomputation of the taxpayer's U.S. tax liability for the year or years affected whenever "accrued taxes when paid differ from the amounts claimed as credits by the taxpayer." Under pre-1987 law, a year-by-year approach was used. A redetermination of U.S. tax was required whenever a foreign tax redetermination with respect to a foreign subsidiary affected the amount of foreign taxes deemed paid by the U.S. shareholder under section 902.

In order to alleviate the problems associated with the year-by-year approach to the determination of deemed-paid taxes, Congress in 1986, revised section 902 of the Code to provide that the U.S. shareholder of a foreign corporation determines the amount of foreign taxes deemed paid by it on the basis of multi-year pools of undistributed earnings and foreign income taxes. Revised section 902 generally applies to earnings and profits accumulated in years beginning after December 31, 1986, and foreign income taxes attributable to those earnings. This change was intended to alleviate the situation in which deemed-paid

¹ Cf. Xerox Corp. v. United States, 41 F.3d 647 (Fed. Cir. 1994), cert. denied, 516 U.S. 817 (1995) and Compaq Computer Corp. v. Commissioner, 113 T.C. 363 (1999) (rejecting the provisional credit theory of the Technical Explanation as applied to a UK subsidiary's surrender of the ACT offset to a lower-tier subsidiary).

foreign tax credits were lost as a result of a deficit in a foreign corporation's earnings and profits. In addition, this change limits the ability of taxpayers to claim a deemed-paid credit that reflects foreign taxes higher than the average rate over a period of years, by averaging the high tax years and the low tax years of the foreign corporation in determining the foreign taxes attributable to the dividend. See H. R. Rep. No. 99-426, 99th Cong., 1st Sess. (1986), 1986-3 C.B. Vol. 2 355-358.

Treas. Reg. § 1.905-3T(d), was issued in 1988 pursuant to the authority granted in section 989(c)(4), and provides that a foreign tax redetermination that affects foreign taxes deemed paid by a U.S. taxpayer under section 902 will be accounted for through an adjustment, on a prospective basis, to the affected pools of post-1986 undistributed earnings and post-1986 foreign income taxes of the foreign corporation. Under the regulations, as subsequently modified by Notice 90-26, 1990-1 C.B. 336, a U.S. taxpayer's tax liability for the year or years affected by a foreign subsidiary's foreign tax redetermination is recomputed only in four limited circumstances, each of which involves an overstatement of the originally claimed credit and none of which applies here.

In this case, under the Technical Explanation to the Treaty earnings and taxes in the payment years are revised to reflect a deemed payment of tax in the offset year. While this is a refund to pre-pooling years, there is no 905(c) adjustment at the shareholder level since no deemed paid credits were claimed in prior years with respect to the ACT paid by [REDACTED] in [REDACTED] through [REDACTED]. However, the ACT carryforward reduces the amount of taxes available for credit with respect to dividends paid out of pre-pooling earnings.

If you have any questions concerning this memorandum, please call Attorney Alice M. Harbutte at ([REDACTED]) [REDACTED] ext. [REDACTED].

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